Wide Angle Shot: CZ & SK - 30 years of independence, yet in close partnership

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At the beginning of 1993, the political map expanded and after a peaceful division, Czechoslovakia was replaced by the independent countries of the Czech Republic and Slovakia. Developments over the last 30 years have often diverged and while the Czech Republic has taken a more proactive approach to integration from the start, Slovakia has managed to push integration further by joining the euro area. After 30 years, the two countries maintain a strong relationship and face new - often similar, often quite different - challenges.

Summary

- After the division of Czechoslovakia, the newly created states forged their own paths. From the beginning, the Czech Republic aspired to integrate fast with the "West", while Slovakia’s path to European integration has been hindered by the populist, nationalist government that ruled the country until 1998.
- In 2004, the paths of the two countries crossed again when they joined the European Union along with other countries. For Slovakia, 2004 was a watershed year, the same year it joined NATO.
- While the Czechs chose the path of gradual integration right from the start but stopped before the crucial step of adopting the euro, the Slovaks, after bad experiences with international isolation, subsequently plunged into integration with great enthusiasm.
- Thanks to extraordinary pro-reform efforts, Slovakia managed to reverse the unfavourable development of the economy. The Czechs, on the contrary, lacked such intensive pro-reform effort because they still did relatively well and the need for unpopular reforms was and still is less intensive or urgent.
- Any comparison of the development of the Czech and Slovak economies slides into a comparison of the Czech Republic without the euro and Slovakia with the euro. This comparison always ends in a stalemate. In our view, the adoption of the euro in Slovakia cannot be separated from the reforms that preceded it and the Euro itself is not a guarantee of prosperity.
- Nevertheless, the euro-adoption-plan has demonstrably increased Slovakia's attractiveness in the eyes of foreign investors, which has contributed to capital inflows, the modernization of the economy, the reduction of the share of outdated heavy industry in the economy and the re-orientation of Slovakia towards Western markets.
- Mainly thanks to the market reforms and less so due to euro adoption, Slovakia began to catch up with the Czech Republic. But the initial gap was huge (incl. outdated economic structure) and even until now Slovakia has not reached the Czech levels. The reported divergence of Slovak GDP per capita in purchasing power parity since 2015 by Eurostat needs to be interpreted carefully since other sources, including the World Bank or National Bank of Slovakia, have not confirmed it. Nevertheless, based on World Bank data, around 2010s the catch-up process in GDP per capita in real

Helena HORSKA
Analyst
+420 234 40-1413
Helena.Horska@rb.cz

Robert PREGA
Analyst
+421 2 5919-1303
Robert_Prega@tatrabanka.sk

terms significantly slowed down compared to Czechia and kept being sluggish ever since. On the other hand, the pandemic shock hit the Czech economy more: while Slovakia reached pre-pandemic level last year, the Czech Republic is one of the few EU countries that are still behind.

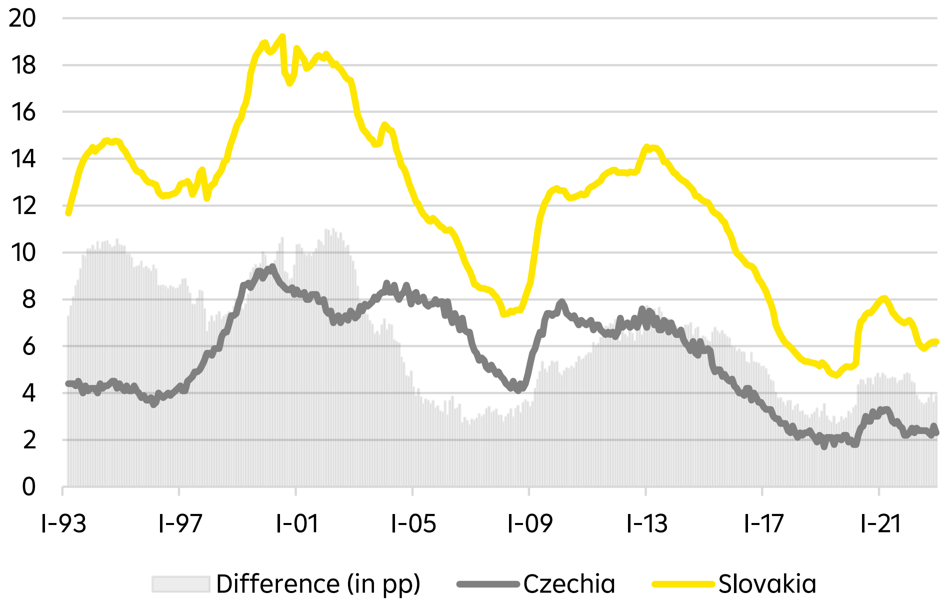
- The price level in Slovakia has been approaching the "Western level" relatively fast compared to the pace of convergence of the country's economic level, and even faster than in the Czech Republic with a permanently lower unemployment rate. While the average price level in the Czech Republic has increased by 350% since the split, in Slovakia it has increased by 430%. The faster growth rate of the Slovak average wages (roughly 710% compared to 680% in the Czech Republic) did not compensate for the increase in the cost of living for Slovak households.
- Both countries are facing new challenges, such as their dependence on the automotive industry, and, even more so in Slovakia, still a high share of energy-intensive sectors.
- The only way to increase structural, and therefore, long-term sustainable growth of both economies, is to develop modern sectors of the economy, diversify customer-supply chains, adapt education to the needs of modern times, encourage investment in modern and sustainable technologies, and deal with ageing population and the associated burden on public budgets.

Slovakia - Success story with bitter ending

Following the peaceful split of Czechoslovakia during the 1992 (effective from 1.1.1993), newly independent **Slovakia lagged behind Czechia by around 50% in terms of GDP pre capita**. New republic firstly needed to complete institutional framework for fully fledged governance of independent state and to secure its credibility on financial markets. Litmus paper of country credibility and economic power is usually its FX rate. In its first months, Slovak government had a hard time to stabilize currency and persuade its citizens that there are no reasons to exchange their savings into foreign currency (DM, czech koruna or US dollar). As economically laggard country with fragile credibility Slovakia was losing its FX reserves at unsustainable rate. National bank was forced to devaluate Slovak currency by 10 % in the middle of the year. Thanks to loans from international organizations (WB, IMF, EIB) the situation cooled down in the second half of 1993. Following years of fixed FX regime were much more stable after harsh start.

Besides managing currency volatility, central bank was also responsible for **maintaining price stability, which was crucial in country recently undergoing liberalization of prices**. Devaluation was another impetus for price increase in 1993 after introduction of VAT tax in the beginning of the year. In the light of fundamental changes, average inflation slightly higher than 20 % yoy was deemed as a success in 1993. Quality of life was negatively influenced by higher prices and double-digit unemployment ranging between 10%-13%. **As it will later turn out unemployment was the long-lasting paint point of Slovak economy.**

Unemployment constantly lower in Czechia



Source: Macrobond, RBI/Raiffeisen Research

The main feature of the following years was a political deflection from the West accompanied by the loss of credibility and growing macroeconomic inner and outer imbalances. Solid GDP growth was accompanied by loose fiscal policy and high domestic demand but also insufficient growth of foreign demand. During the years 1994-1998 Slovak republic was not included in the first round of NATO enlargement and was excluded from EU accession negotiations. **At the end of this era, the Slovak economy was on the verge of bankruptcy** on state debt and the central bank was forced to leave the fixed FX regime due to the unsustainability of interventions.

Parliamentary elections in 1998 have brought significant change in both the political and economic orientation of Slovakia. The renewed effort to integrate still young republics into western political-economic structures was a success story. **In 2004, Slovakia has entered both strategically important groups NATO and EU.** This success story was, however, achieved at the expense of socially difficult reforms and liberalization of prices. The price of bringing the economy back on track and securing its macroeconomic stability was two years of double-digit inflation (1999, 2000) and several years of unemployment reaching high levels close to 20%. The first signs that Slovakia is on the right way were significant investments in the automotive industry. In the years 2003 and 2004, PSA Peugeot (currently Stellantis) and KIA decided to build their production plants in the country.

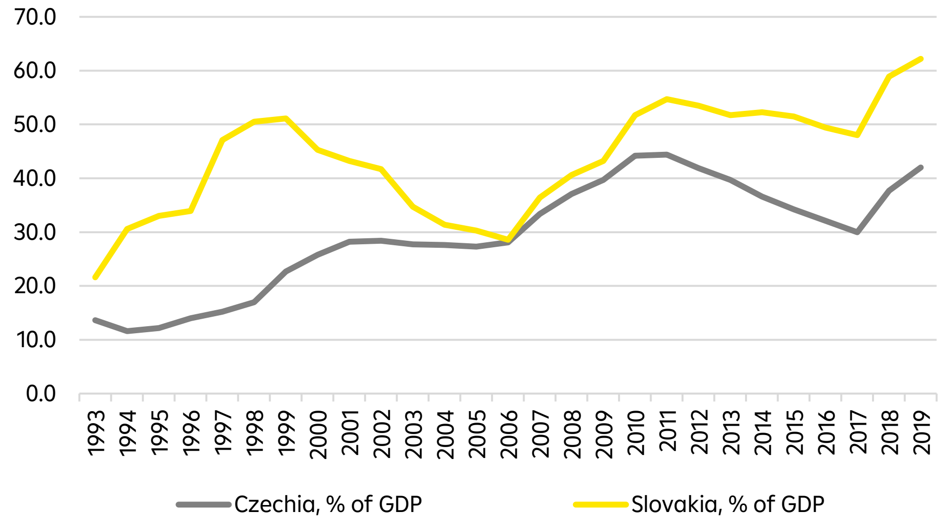
Among the decisive factors were a favourable geographical position in the middle of Europe, a skilled labour force, political and macroeconomic stability. Taking into account the already existing Volkswagen factory, **Slovakia became the biggest car producer per capita in the world.**

A business-friendly environment was able to attract many other investors, stimulate economic growth and create thousands of jobs. **After the mild recession in 1999, the Slovak economy was almost constantly accelerating its growth up until 2007 when the GDP dynamic peaked at 10,8% yoy.** The process of catching up to the average GDP per capita in EU27 was the fastest during this period. Due to strong employment growth, even the unemployment rate was for the first time in the history of the Slovak republic below 10% in 2007.

After the EU and NATO entry, the next milestone for the Slovak republic was accession into the European monetary union. **Economic policies were thus focused on reaching Maastricht convergence criteria.** In a time of booming economy, it was especially difficult to keep inflation within the given range. But thanks to the time coincidence of Slovak EMU entry and the financial crisis in 2009, doubts about the sustainability of inflation development were quickly forgotten, as there was a worldwide lack of inflation. The accession process was thus successfully completed, and Slovakia entered EMU with a conversion rate of 30.123 on 1.1.2009. The Slovak crown appreciated by 30 % since 1999.

The Slovak economy, being already highly integrated into the international economic structures, was hit hard by the financial crisis. Its GDP slumped by -5.5 % yoy. However, recovery was quick and supported by expansive fiscal policy. The public finance deficit reached -8,1% of GDP in 2009 and -7.5% of GDP in the following year. The issue of the health of public finances in some European countries arose as a crucial topic in 2010 when Greece had problems paying its debt obligations. Slovakia entered the financial crisis with a solid debt level of only 28% of GDP in 2008. However, even after negative development during the aftermath of the financial crisis, the topic of fiscal position was not so imminent compared to the EU average with indebtedness reaching only 52% of GDP in 2012.

Higher dynamic of Slovak government debt



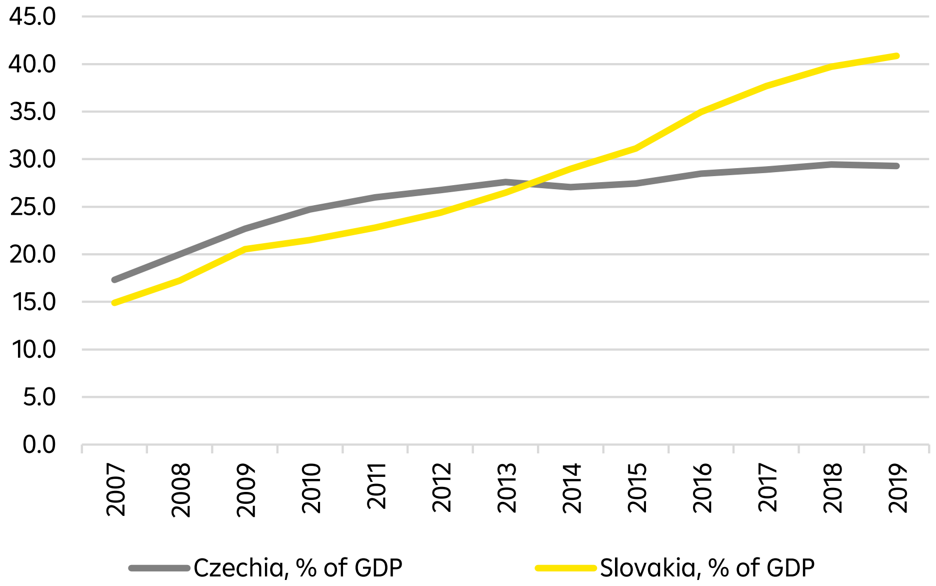
Source: Macrobond, RBI/Raiffeisen Research

Besides global issues and accomplishment of all the integration milestones, Slovakia also needed to tackle structural changes in its educational and healthcare system and build transport infrastructure to avoid falling into the middle-income trap. **Catch up process in GDP per capita in real terms has significantly slowed down compared to Czechia around 2010 and kept being sluggish ever since**, according to World bank data. Moreover, during these stable years, which someone can also call stagnation, falling behind in above mentioned areas like healthcare and education became more and more obvious.

Slovakia had very good cards in hand: low interest rates, structural funds, and macroeconomic stability. Effective spending of EU structural funds should have been a priority of this period as a tool to increase potential GDP growth and quality of life. **However, Slovakia, unfortunately, proved incapable to use the EU funds timely and effectively.** The bulk of spending is usually processed ineffectively at the last moment.

The second decade in this millennium was specific mainly by low interest rate. Especially in Slovakia, this era was underpinned by membership in the eurozone and one of the lowest rates of housing loans in Europe. Historically low interest rate environment did motivate Slovak households to increase their loan exposure to GDP from the lowest in the CEE region to the highest in 2014. This development ignited the growth of the real estate prices once again after the first steep increase stimulated by EMU pre-accession euphoria during the few years before 2008 driven mainly by demand from abroad. This time, the rally was induced by domestic demand with intention of capital investment as Slovakia doesn't have a functional capital market. During the period 2014-22 property prices more than doubled.

Increasing household debt forced National bank of Slovakia to strengthen regulation



Source: Macrobond, RBI/Raiffeisen Research

Neither households nor state were motivated to prudent behaviour and thus indebtedness grew. Despite solid economic growth and favourable conditions, the state budget has never been even balanced. After unprecedented crises like COVID-19 and war in Ukraine that necessitated fiscal stimuli, the debt-to-GDP ratio is expected to have reached 60% in 2022.

The negligence of the healthcare system contributed also to the mismanagement of the COVID crisis and the weak ability to cope well with the pandemic resulting in an excessive number of deaths per 1000 people compared to other countries. The results of our pupils in math and their ability to read with understanding are among the worst in Europe. With the exception of Luxembourg, Slovakia has the highest ratio of students attending a foreign university in Europe. At the same time, the Slovak population is ageing at one of the fastest paces in Europe. **Addressing these issues as quickly as possible is crucial for the coming years.**

Czech Republic - An (unfinished) story of integration

After the division of Czechoslovakia, the newly formed states forged their own path. **From the beginning, the Czech Republic aspired to early integration with the more advanced western economies and looked up to its market principles.** With big aspirations in mind, the first major test came early, in the late 1990s. The rapid opening of the Czech economy, including full convertibility of the national currency, contributed to economic growth and foreign capital inflows, but it also revealed weaknesses. **The exchange rate, fixed by the Czech National Bank, got under increasing pressure** to the point when in 1996 the CNB had to widen the fluctuation band. Shortly after, in May 1997, the outbreak of the financial crisis in Southeast Asia led to an outflow of money into safer currencies with repercussions for the Czech koruna. This resulted in a vain attempt by the Czech National Bank to maintain its fixed exchange rate regime at all costs. However, the course was swift and, within two weeks, the CNB gave up its efforts and announced that from now on the Czech currency would operate under a **managed floating exchange rate regime**. Since then, the CNB occasionally used FX interventions to fulfil its price stability mandate.

Along with the retreat from the fixed exchange rate policy, the CNB also stopped using money supply targeting in 1998 and **switched to the then relatively new monetary policy regime of inflation targeting**. The National Bank of Slovakia (NBS) followed a similar path, switching to a managed float rate after devaluation pressures in 1998 and later to an inflation-targeting regime in 2000.

Both currencies came under pressure at the turn of the millennium

Source: Macrobond, RBI/Raiffeisen Research

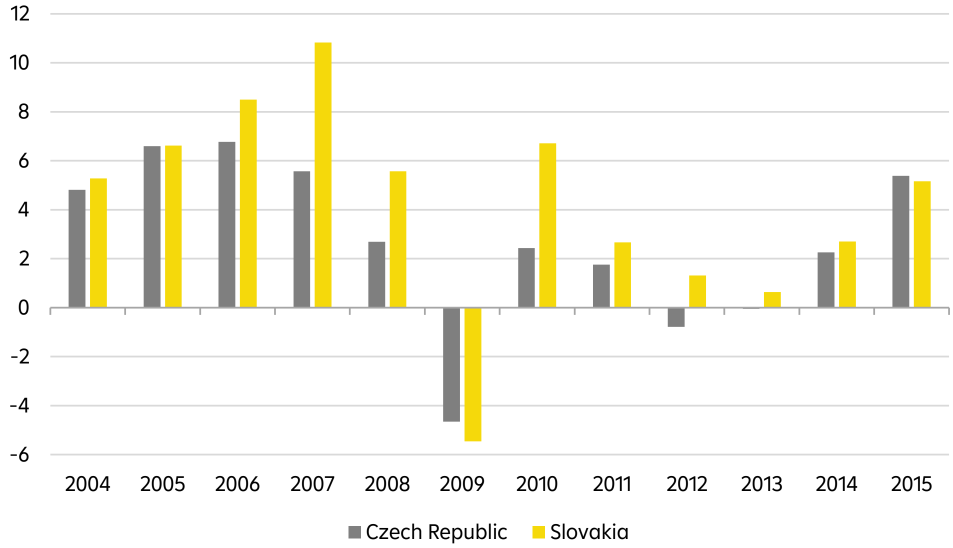
After the currency crisis passed, the Czech economy went through a slowdown and an unprecedented rise in unemployment, which was a relatively new experience for the formerly communist regime relying on full employment. While between 1993 and 1997, the unemployment rate hovered around 4%, it rose markedly to 10% by the turn of the millennium. The situation was even worse in Slovakia with the unemployment rate exceeding 10% already since the division of Czechoslovakia and later, in the early 2000s, rising quite rapidly to 20%. **For many Czech residents, the turmoil in the labour market triggered uncertainty causing approval ratings of the reformist right-wing government to drop.**

However, the turn of the millennium did not bring only negative developments. **In 1999, the Czech Republic joined NATO** together with Poland and Hungary, overtaking Slovakia, which has become a member five years later. Continuing to deepen its ties with other European countries, **the Czech Republic joined the European Union in 2004 as part of the "east expansion" of the bloc**, this time together on a par with Slovakia. In the following years, both Czechia and Slovakia benefited from deeper integration into the EU single market. The pace of foreign investment flows has increased, especially in the automotive sector. **For the first time ever, the Czech foreign trade balance has turned into a surplus launching a golden episode of economic growth**, rising productivity and an increasing pace of convergence to the more developed EU neighbours.

In 2008, however, the global financial crisis was fully underway causing GDP to tumble and credit conditions to tighten. In 2009, the Czech Republic's GDP fell by 4.7%

compared with the previous year, while the Slovak economy was hit even harder, declining by 5.5%. Nevertheless, in the following years, Slovakia's economy — sometimes referred to as the "Tatra tiger" — grew stronger than the Czech Republic's economy, partly thanks to Slovakia's reform measures made in an attempt to join the eurozone quickly.

Slowly growing Czech economy vs. boom-and-bust Slovak economy
Real GDP (% yoy, SA)



Source: Macrobond, RBI/Raiffeisen Research

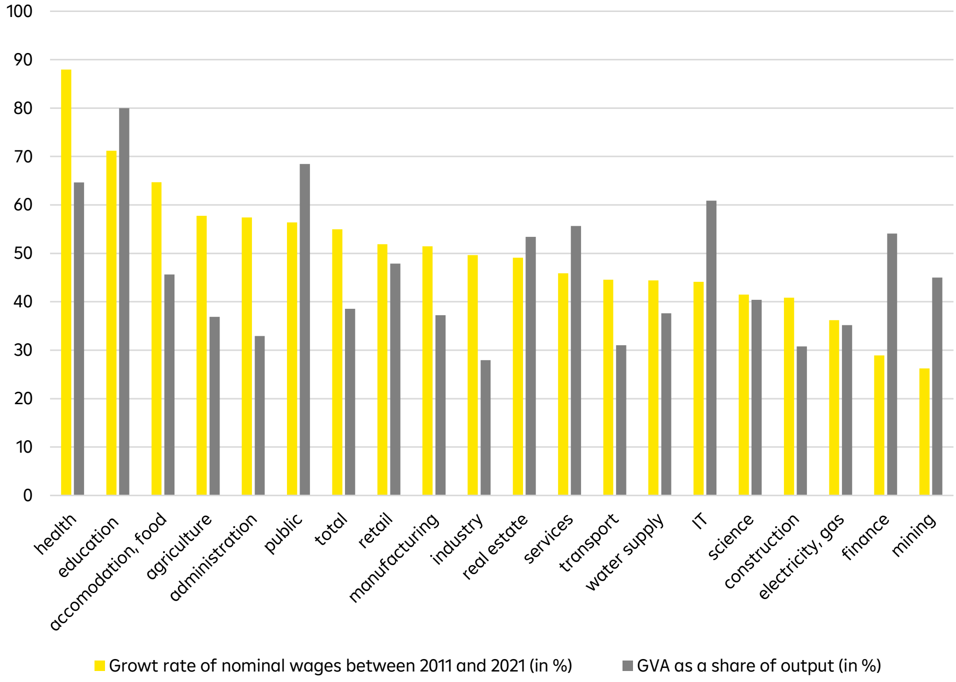
European economies and financial markets got into another (or rather follow-up) turmoil in the early 2010s triggered by the **eurozone sovereign debt crisis.** The Czech economy contracted (quarter-over-quarter) in five consecutive quarters starting in Q1'12, while the Slovak economy narrowly avoided falling into a technical recession. **At the same time, inflationary pressures started building up.** By mid-2011, the headline year-on-year inflation rate in Czechia moved close to the 2% inflation target before exceeding 3% during 2012 as the CNB kept interest rates low to spur the economy. Still, underlying inflationary pressures remained subdued with the core rate below zero in year-on-year terms. This gave the CNB some room to support the muted economy. **After hitting the lower bound on interest rates, the central bank initiated FX interventions in favour of a weaker exchange rate thereby easing monetary conditions further.** This has helped to keep Czech sovereign yields on a downward path in sync with the eurozone countries despite the fact that as a non-eurozone member Czechia has never been under the safety umbrella of rescue facilities, such as the European Stability Mechanism, established in September 2012.

With the 2012-13 recession further in the past, the Czech economy started to build up again and resumed its convergence with the more advanced economies in the EU. Czechia managed to generate higher GDP growth rates than Germany and the eurozone and moved closer to both countries in terms of GDP per capita in purchasing power parity. **A milestone was reached in 2017 when Czechia overtook the Spanish economy.** With the economy moving ahead swiftly, the need for loose monetary policy disappeared. The CNB thus decided to abandon its accommodative stance by gradually raising interest rates, thereby diverging from the ECB that stuck to zero rates policy in an attempt to stimulate the low-inflation environment.

With solid GDP growth, the high unemployment rate was just a distant memory from the 1990s. Due to increasing economic activity, labour demand was high and the labour market was getting tight. This resulted in a swift wage growth. **Between 2011-2021, average nominal wages increased by 55%.** Looking at individual industries, wages grew the most in the health sector (+88%) and the least in mining & quarrying

(+26%), while increasing by 52% in manufacturing, the cornerstone of the economy. Interestingly, inspecting the chart below, there is little evidence that sectors with relatively high value-added as a share of output enjoyed higher wage growth. This observation, however, assumes that value-added as a share of output is time-invariant. Worth noting is also that between 2014-2020, unit labour costs have outpaced labour productivity, which poses a cost burden for employers and lowers the economy's competitiveness. In contrast, in Slovakia, labour productivity growth exceeded unit labour costs over the same time period.

Higher share of gross value added proved to be no guarantee of higher wage growth



Calculations are based on OECD Input-Output tables
Source: OECD, RBI/Raiffeisen Research

While the economy was getting richer, it was also getting more complex, or put differently, more diverse. The empirical literature suggests that there is a positive relationship between wages and complexity. According to Harvard's Atlas of Economic Complexity, Czechia is placed as the sixth highest country in the economic complexity index (ECI) ranking, suggesting that its economy is actually more complex than expected for its income level, which leaves room for growth in the future. The same applies for Slovakia, placed 13th in the same ranking.

As history tends to repeat itself, the period of economic prosperity was once again put on hold. A significant turnaround occurred almost overnight with the outbreak of the covid-19 pandemic in early 2020. **After several years of growth, the Czech economy fell by 5.5% throughout 2020 and the subsequent recovery has not been particularly dynamic, at least compared to the rest of the EU.** Consequently, the Czech economy remains one of the few European economies still trending below the pre-Covid level by the end of 2022. For comparison, Slovakia's economy reached the pre-Covid level in the first half of 2022. Nevertheless, it seems that the Czech economy could already be close to a turning point with the prospect of economic growth, albeit a moderate one. The reason is that there are limits to growth, such as **significantly higher inflation compared to the eurozone hurting competitiveness**, lower fiscal space (i.e., high structural budget deficit, swift rate of debt increase in EU-comparison, and structural shifts (e.g., clean-energy transition, the transition of the automotive sector, rewiring of global supply chains, changes in globalization).

And on contrary to Slovakia, the final decision to adopt the common EA currency has not yet been made. However, gradual "euroisation" of the Czech business sector is underway. The ratio of euro-denominated loans to total loan creation has increased from 3% (in the year 2000) to 23% currently. The observed trend gained pace towards the end of 2022 when nearly half of newly created corporate loans were denominated in euro. Household debt has increased from 4% to 31% of GDP between 1993 until recently. Still, compared to other countries, Czech retail banking has plenty of room to grow.

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CZ	07.06.2022	Under Revision	Czech Republic
SK	27.10.2022	Under Revision	Slovakia
SK	14.04.2022	Under Revision	Slovakia

History of long term recommendations			
Symbol	Date	Recommendation	Company
PL	29.04.2022	Not rated	Poland
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CZ	07.06.2022	Not rated	Czech Republic
SK	27.10.2022	Not rated	Slovakia
SK	14.04.2022	Not rated	Slovakia

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Thomas SternbachLegal and ComplianceRaiffeisen Bank International AGAm Stadtpark 9, 1030 WienTel: +43-1-71707-1541Fax: +43-1-71707-761541thomas.sternbach@rbinternational.com

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FABIAN BLASCH
Austria ,
fabian.blasch@rbinternational.com

GUNTER DEUBER
Austria ,
gunter.deuber@rbinternational.com

CASPER ENGELEN
Austria ,
casper.engelen@rbinternational.com

AMADEA HIESS
Austria ,
amadea.hiess@rbinternational.com

MATTHIAS REITH
Austria ,
matthias.reith@rbinternational.com

GOTTFRIED STEINDL
Austria ,
gottfried.steindl@rbinternational.com

MARKUS TSCHAPECK
Austria ,
markus.tschapeck@rbinternational.com

FRANZ ZOBL
Austria ,
franz.zobl@rbinternational.com

BRISIDA BUZI
Albania ,
Brisida.BUZI@raiffeisen.al

VALBONA GJEKA
Albania ,
valbona.gjeka@raiffeisen.al

FJORENT RRUSHI
Albania ,
Fjorent.Rrushi@raiffeisen.al

ARISTEA VLLAHU
Albania ,
Aristea.Vllahu@raiffeisen.al

OLGA ZHEGULO
Belarus ,
olga.zhegulo@priorbank.by

ASJA GRDJO
Bosnia Herzegovina ,
asja.grdjo@raiffeisengroup.ba

IVONA ZAMETICA
Bosnia Herzegovina ,
ivona.zametica@raiffeisengroup.ba

MIRZA ZORNIC
Bosnia Herzegovina ,
mirza.zornic@raiffeisengroup.ba

ANA LESAR
Croatia ,
ana.lesar@rba.hr

ELIZABETA SABOLEK-RESANOVIC
Croatia ,
elizabeta.sabolek-resanovic@rba.hr

ZRINKA ZIVKOVIC-MATIJEVIC
Croatia ,
zrinka.zivkovic-matijevic@rba.hr

HELENA HORSKA
Czech Republic ,
Helena.Horska@rb.cz

LENKA KALIVODOVA
Czech Republic ,
Lenka.Kalivodova@rb.cz

DAVID VAGENKNECHT
Czech Republic ,
david.vagenknecht@rb.cz

VRATISLAV ZAMIS
Czech Republic ,
Vratislav.Zamis@rb.cz

LEVENTE BLAHÓ
Hungary ,
levente.blaho@raiffeisen.hu

GERGELY PÁLFFY
Hungary ,
gergely.palffy@raiffeisen.hu

ZOLTÁN TÖRÖK
Hungary ,
torok.zoltan@raiffeisen.hu

DOROTA STRAUCH
Poland ,
dorota.strauch@raiffeisen.pl

NICOLAE COVRIG
Romania ,
Nicolae.Covrig@raiffeisen.ro

ANDREEA-ELENA DRAGHIA
Romania ,
Andreea-Elena.DRAGHIA@raiffeisen.ro

IONUT DUMITRU
Romania ,
Ionut.Dumitru@raiffeisen.ro

ANASTASIA BAYKOVA
Russia ,
ABAIKOVA@raiffeisen.ru

GREGORY CHEPKOV
Russia ,
grigory.chepkov@raiffeisen.ru

STANISLAV MURASHOV
Russia ,
stanislav.murashov@raiffeisen.ru

LJILJANA GRUBIC
Serbia ,
ljiljana.grubic@raiffeisenbank.rs

BORIS FOJTIK
Slovakia ,
boris_fojtik@tatrabanka.sk

TIBOR LORINCZ
Slovakia ,
tibor_lorincz@tatrabanka.sk

ANDREJ MARTISKA
Slovakia ,
andrej_martiska@tatrabanka.sk

ROBERT PREGA
Slovakia ,
Robert_Prega@tatrabanka.sk

SERHII KOLODII
Ukraine ,
serhii.kolodii@raiffeisen.ua

OLEKSANDR PECHERYTSYN
Ukraine ,
oleksandr.pecherytsyn@raiffeisen.ua

Imprint

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